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# The *Ralls* implications for the National Security Review

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## Abstract

The potential national security effect of foreign acquisitions has been a long standing issue facing the host states worldwide, which holds particular true between those adversary nations, like the United States and China. Such unexpected consequences as plausible protectionism and governance discrimination are detrimental to the global economic recovery. The creation of China's own national security review (NSR) regime complicates further the perceived retaliatory measures. To pierce the veil of the Committee on Foreign Investment in the United States' (CFIUS) process of NSR is conducive to mitigating unnecessary stalemate between the two world economic giants in the scenarios of cross-border investments. *Ralls* serves as a landmark case for a Chinese company to challenge the US President's and CFIUS's divestiture orders. It remains uncertain of the extent to which the CFIUS's future NSR assessment procedures will be reshaped followed by the US executive's setback in the lawsuit. Through maintaining a predictable regulatory landscape, it is crucial to strike a balance between encouraging foreign investment and protecting national security.

## Introduction

Globalisation provides China with financial capital and advanced technologies to expand its geopolitical clout as well as overseas commercial accesses.<sup>1</sup> Merger and acquisitions (M&As) are the predominant form of entry of foreign direct investment (FDI) worldwide. Chinese multinational companies (MNCs), some of which are state-owned enterprises/national champions, attempt to acquire American firms that deal with strategic assets or critical infrastructures.<sup>2</sup> Sany Electric is a China-based global manufacturing company to produce wind turbines. *Ralls*, a Delaware company owned by two Chinese nationals who are also senior executives of Sany, sought to acquire four wind farm projects in Oregon. The assets are near restricted Navy airspace. *Ralls* was ordered by the US President to disinvest its acquisition of the target projects. It then filed suit, alleging that the Presi-

dent has exceeded his authority under the Administrative Procedure Act.<sup>3</sup> Although the grounds of the Appeal of Court's reversal are narrow, the decision represents a sharp rebuke to the opaque procedures used to conduct national security review (NSR) of foreign investments in the US. There is a particularly notable lack of consensus on how to treat transnational M&As that raise questions of national security. It remains challengeable to balance two plausible values, ie, promoting an open market and protecting national security.<sup>4</sup> The paper takes a comparative look at the enforcement agencies' review of foreign M&As on the ground of national security.

The paper proceeds in five parts. Part I introduces the CFIUS, which is designed to scrutinise the national security implications that might emerge from foreign takeovers of US firms.<sup>5</sup> The current mechanism leaves the CFIUS and President's interpretation of the NSR unchallenged prior to the case of *Ralls*. Part II looks into *Ralls*' argument that the President exceeded his statutory authority by ordering the plaintiff to unwind its operation in Oregon, and that it was deprived of due process. The court did not challenge the national security merits of the President's decision, but rather the way in which he implemented it. Part III addresses challenges *Ralls* poses to the national security through a depoliticised regulatory process, with a particular focus on national critical infrastructure (NCI). A rigorous analysis about the perceived discrimination based on nationalities is developed in this part. It is concerned that acquisitions by companies from China are receiving more intense scrutiny than acquisitions by those from its close allies.<sup>6</sup> The rules and regulations should be transparent, consistent and applied equally, regardless of where foreign investors are from. Part IV discusses implication arising from the US paradoxical protections measures, which may deter foreign investment and precipitate retaliation. Part V sets forth some suggestions highlighting that an efficient compliance governance represents a most practical resolution to the status quo of the stalemate. The voluntary filing to CFIUS is highly advocated, due largely

to the fact that any failure to do so remains subject indefinitely to divestment or other sanctions. A tentative conclusion is provided in the final part, reaffirming that it is vital to strike a balance to safeguard national security without stifling free trade and innovation.

## **A. The Committee on Foreign Investment in the United States (CFIUS)**

The Committee on Foreign Investment in the United States (CFIUS) is an inter-agency group charged with reviewing whether a proposed foreign acquisition would compromise US national security.<sup>7</sup> Its scrutiny encompasses not only defence sectors and dual-use technologies, but also critical infrastructure. Furthermore, the Act grants the President authority to block mergers, acquisitions or takeovers involving foreign entities if they threaten to impair national security.<sup>8</sup> The President acts only after reviewing the record compiled by CFIUS.<sup>9</sup> Such a practice is plausibly driven by the statute, which expressly exempts the President's determination from judicial review.

### **1. The establishment of the CFIUS under the Exon-Florio Amendment**

The Committee on Foreign Investment in the United States (CFIUS) was established under the Defence Production Act of 1950, also known as the 'Exon-Florio Amendment'.<sup>10</sup> The CFIUS vets foreign takeovers of US assets, which is tasked with reviewing foreign nationals' acquisitions to determine whether the transactions would affect US national security.<sup>11</sup> Congress granted CFIUS the authority to 'negotiate, enter into or impose, and enforce any agreement or condition' in order to mitigate any threat to the national security that arises as a result of the covered transaction.<sup>12</sup> After notification, the CFIUS has 30 days to conduct an initial review, and if it deems that a statutory investigation is necessary, it has another 45 days to investigate, after which it decides to either permit the acquisition or recommend the President to block the transaction.<sup>13</sup> In accordance with Exon-Florio, the President delegates his authority to review such transactions to the CFIUS.<sup>14</sup> Only if CFIUS determines that the measure did not mitigate the threat does the President have an opportunity to act.<sup>15</sup> If recommended for prohibition, the President has another 15 days to make a final decision.<sup>16</sup> Such action is considered as a last resort, only enforceable after the President has concluded that no other alternative remedies are adequate to protect national security.

CFIUS was significantly amended by the Foreign Investment and National Security Act of 2007 (FINSAs), which increases congressional oversight, broadens the scope of factors for CFIUS to consider, and formalises CFIUS's practice of negotiating remedies with the parties.<sup>17</sup> The statute contains a finality provision which states:

'[t]he actions of the President under paragraph (1) of subsection (d) of this section and the findings of the President under

paragraph (4) of subsection (d) of this section shall not be subject to judicial review.'<sup>18</sup>

Only once did the President actually invoke his authority to block a transaction.<sup>19</sup> In practice, a significant portion of CFIUS activity is conducted through informal mechanisms, where the transacting parties engage in discussions with the CFIUS even before the formal 30-day review period and often modify terms to obtain clearance. If modification is unviable, parties normally withdraw a deal.<sup>20</sup>

### **2. The widened definition of national security**

The term 'national security' is not defined in the statute and is construed broadly by CFIUS to include all facts and circumstances that have potential national security implications. There remains no clear indication of when a foreign acquisition constitutes a national security threat and what sort of transactions are likely to be rejected on national security grounds. The term national security is interpreted broadly for purpose of Exon-Florio review. CFIUS has explicitly rejected the concept of 'economic security' in the definition of national security, although as a practical matter CFIUS does consider economic issues if they affect national security.<sup>21</sup> FINSAs has significantly broadened the US's definition to include many sectors of the economy previously beyond CFIUS's purview. Notably, it seems that FINSAs still deliberately avoids referring to 'national economic security'.<sup>22</sup> The changes in law make it evident that the definition of national security has substantively expanded with the effects of FINSAs and the Department of Homeland Security (DHS)'s presence broadening CFIUS's mandate.<sup>23</sup> It is worth examining whether CFIUS is equipped adequately to take measures to mitigate that risk, or even block the investment in case of any national security issues.<sup>24</sup>

## **B. *Ralls Corp v Barack H Obama, et al***

In March 2012, Ralls, an Oregon corporation owned by two Chinese nationals who also hold senior management positions within the Sany Group China (Sany), acquired interests in four wind farm project companies from Terna Energy USA Holding Corporation (Terna). The wind farms are all within or in the vicinity of restricted air space at Naval Weapons Systems Training Facility Boardman in Oregon.<sup>25</sup> Companies involved in transactions likely to be reviewed can file a voluntary notice seeking review under the Act.<sup>26</sup> However, Ralls neither voluntarily notified CFIUS of the transaction nor sought its approval prior to closing their deal. Before the end of the first 30-day review, CFIUS determined that there existed credible evidence to show the transaction posed national security risks on the critical infrastructure.<sup>27</sup> Ralls was then given 90 days to divest all interest and 14 days to remove all facilities from the sites. The President, recommended by CFIUS,<sup>28</sup> issued an order to divest Ralls' ownership in the target project on 28 September 2012.<sup>29</sup> The Order was based on account of 'credible evidence' indicat-

ing that the parties, 'through exercising control of the [companies,] might take action that threatens to impair the national security of the United States.'<sup>30</sup> The decision reaffirms the President's broad authority under the Exon-Florio Amendment to block foreign acquisitions on the basis of national security concerns. Arguably, neither CFIUS nor the President gave Ralls notice of the evidence on which they relied in issuing their orders, nor any opportunity to rebut that evidence.<sup>31</sup> The core issues before the court to determine whether the presidential actions on national security grounds shall be subject to judicial review, and whether the restriction should extend to constitutional issues raised by CFIUS transactions.

### **1. The landmark lawsuit against the CFIUS and the President of the United States**

Ralls took an unprecedented step to challenge the authority of the CFIUS and the President for thwarting the acquisition on 12 September 2012.<sup>32</sup> It alleged that the presidential and CFIUS had violated the Exon-Florio Amendment and the Administrative Procedures Act (APA), and it was an unconstitutional taking of property without due process of law.<sup>33</sup> The action was before the Court on defendants' motion to dismiss for lack of subject matter jurisdiction. The US District Court for the District of Columbia found that Ralls had no protected property interest in the four wind farm project companies because it had acquired the companies subject to the known risk of divestiture under the President's CFIUS authority.<sup>34</sup> The District Court also determined that Ralls' ability to interact with CFIUS was sufficient due process for the sake of the protecting the national security.<sup>35</sup> On 26 February 2013, the court declined to review the President's findings on the merits, and dismissed Ralls' claims of violations of the Exon-Florio Amendment and the APA as beyond the scope of judicial review.<sup>36</sup>

The President is traditionally given wide latitude to decide matters related to national security. He has the authority to review and block an investment if 'there is credible evidence that leads the President to believe ... [the investment] threatens to impair the national security.'<sup>37</sup> The President's exercise of his discretion that Congress has left to his sole discretion is unreviewable by the courts, particularly in matters of national security.<sup>38</sup> Judicial review of this claim would deprive Congress' finality clause of its true effect.<sup>39</sup> In response to Ralls's request for a right to judicial review, it is ascertained that the Administrative Procedure Act (APA) does not confer jurisdiction on Article III courts to review actions of the President.<sup>40</sup> Apparently, the Presidential Order aimed to strengthen the government's hand in conducting foreign investment policy and mitigate any potential threat to the national security.<sup>41</sup> It is not within the role of the courts to second-guess executive judgments made in furtherance of the branch's role.<sup>42</sup> It remains final and cannot be overturned by the courts.<sup>43</sup> As such, the court has been traditionally reluctant to exercise judicial review when a plaintiff seeks an order of

the court that will bear directly on the President.<sup>44</sup> It can be argued that the court has narrowly construed the circumstances under which a challenge to presidential action will be found unreviewable,<sup>45</sup> that is, the findings of the President shall not be subject to judicial review.<sup>46</sup>

### **2. Appeal: unconstitutional deprivation of property without due process**

Given the setback, Ralls has brought a due process claim that raises purely legal questions about the process that was followed in implementing the statute. On 7 February 2014, Ralls filed an appeal of the DC Circuit Court's ruling that:

'Count IV alleges that the CFIUS Order and the Presidential Order violate the Due Process Clause of the Fifth Amendment to the United States Constitution as unconstitutional deprivations of property without due process of law.'<sup>47</sup>

The DC Circuit disagreed with the lower court and held that Ralls' vested property interest could not be deprived without first notifying Ralls of the official action, providing Ralls access to the unclassified evidence on which the President relied, and affording Ralls an opportunity to rebut that evidence.<sup>48</sup> On 15 July 2014, the court found that President Obama's order deprived Ralls of its right to due process under the law,<sup>49</sup> and reversed the District Court decision. Due to the procedural defects, it was held that due process required 'at the least' that the parties be afforded:

'(1) notice of the official action;

(2) access to the unclassified information "on which the official actor relied,"; and

(3) an opportunity to rebut that evidence.'<sup>50</sup>

The President does have an unreviewable right 'to suspend or prohibit any covered transaction that threatens to impair the national security of the United States', nevertheless, it does not preclude 'the reviewability of a constitutional claim challenging the process preceding such presidential action.'<sup>51</sup> The due process clause of the Constitution's Fifth Amendment provides that no person shall be 'deprived of life, liberty, or property, without due process of law.'<sup>52</sup> The court has not ruled on the merits of this challenge, but simply found that it has jurisdiction to hear this claim that the Presidential Order deprives it of property without due process of law.<sup>53</sup> Thus, the court confirmed that it has jurisdiction to determine whether the President has followed proper procedures in exercising the discretion. The Court of Appeals has remanded the case back to DC District Court, with instructions that Ralls be provided adequate due process, as well as an opportunity to rebut such information. It was also notable that the US government can appeal this decision to the Supreme Court of the United States.<sup>54</sup>

Despite Ralls' due process claim, an inherent difficulty is the fact that CFIUS's risk assessment for any particular transaction is based on classified information that is generally not susceptible to public disclosure.<sup>55</sup> The executive branch is legitimately obliged



to reveal only unclassified information used to block the acquisition. Certain ‘capability’ and ‘intent’ assessment of transactions are completed by the nonvoting intelligence agencies, like the National Security Agency (NSA) and Central Intelligence Agency (CIA).<sup>56</sup> The legal mandate is reinforced by the determination of the US intelligence agencies to keep their assessments secret so as not to reveal ‘sources and methods’ used in their investigations.<sup>57</sup> Therefore, the President shall not be permitted to divulge the evidence and reasoning on which his divestiture order was based. The secrecy is essential to protect the national security interests, but it would risk devolving into unprincipled protectionism.<sup>58</sup> Between valuable investment and security interests, it is hard to neutralise one value over another, which raises a question of the extent to which how the NSR mechanism is to be transparent and subject to public scrutiny. It remains uncertain how the President could provide to Ralls to explain his decision in light of the classified nature of the CFIUS process.<sup>59</sup> The *Ralls* case entails the judiciary to develop jurisprudence on a fundamental question, that is, how much due process should be owed to foreign acquirers undergoing CFIUS reviews.<sup>60</sup>

### C. The *Ralls*’ far-reaching repercussions

The case of *Ralls* to challenge the CFIUS process in court may have raised a legitimate question about how CFIUS operates. It was the first time that a President invoked his authority to block an investment under Section 721 of Defence Production Act of 1950 in nearly 25 years.<sup>61</sup> It was also the first time where the judiciary was called upon to resolve the administrative dispute.<sup>62</sup> The ruling represents a plausible win for *Ralls* that confronted the CFIUS’s national security concerns. The case shows how essential it is to notify CFIUS voluntarily prior to an acquisition. Had *Ralls* done so, it might have been possible to work out some mitigation arrangement that would have allowed at least some part of the transaction to go through.

#### 1. The interpretation of national critical infrastructure (NCI)

There must be effective procedures in place to assess risks arising from potential investment in the critical national infrastructure (CNI). The focus on protection of CNI is an evolving national security objective, and may have different implications in various regulatory contexts.<sup>63</sup> Intrinsically, allowing more than one agencies to apply their own definitions ensures that a broad ranges of interests are represented, weighed and balanced as part of the integral review process.<sup>64</sup> FINSA defines the term as ‘systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security’.<sup>65</sup> However, the statutory definition used by DHS is ‘systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on security, national economic security, national public health or safety, or any com-

bination of those matters.’<sup>66</sup> It can be seen that the two definitions do not match exactly each other, which are subject to the enforcement agencies’ interpretation and discretion. Although FINSA includes NCI in the definition of national security, the CFIUS regulations specifically reject defining classes of systems or assets as ‘critical infrastructure.’<sup>67</sup> CFIUS’s mandate does not include national economic security, which is significantly narrower than DHS’s focus and vague in its application. CFIUS has the power to determine the effects of the transaction on the US national security.<sup>68</sup>

The American government is particularly concerned about protecting the US defence apparatus from espionage. The proximity of the Oregon Projects to a US Naval Weapons System Training Facility was likely a significant factor in the CFIUS assessment. It reviews particularly those investments that involve facilities in proximity to sensitive installations. CFIUS had effectively blocked a previous transaction in which a Chinese state-controlled firm sought to acquire a gold mine near military assets.<sup>69</sup> Due to the proximity of the target project to the military installation, CFIUS found that the transaction at issue might threaten to impair the national security. On the one hand, the flexibility of the language is critical to the CFIUS’s proper functioning. On the other hand, the lack of a specific, limited definition of ‘national security’ arguably subjects foreign investments to an arbitrary and capricious review process.<sup>70</sup>

#### 2. The perceived nationality discrimination

The broad definition of national security may enable the CFIUS to politicise foreign investment by disfavoured countries, such as China, which might represent a threat to US economic hegemony.<sup>71</sup> The prospective purchaser’s nationality and whether it is controlled by a foreign government are important factors in determining whether a CFIUS review is necessary. Some companies are scrutinised more than others by virtue of their nationality, which may influence the CFIUS process.<sup>72</sup> Transactions involving Chinese acquirers perceived as non-alliance are likely subject to greater scrutiny than those within its alliance, such as the EU. Notably, there are other wind farms owned by foreign companies in the proximity of the airbase, but *Ralls*’s wind farms were singled out. It is perceived that companies from countries that have weak corporate governance or have a history of espionage will be subject to higher scrutiny.<sup>73</sup> CFIUS seems to be more suspicious of some ostensibly private Chinese firms as insufficiently distinct from those owned or controlled by the Chinese government. This normally result in heightened scrutiny of national champions irrespective of whether they are officially state owned enterprises (SOEs).<sup>74</sup>

The plausible discrimination could lead to retaliatory measures to the detriment of American investors attempting to enter into the Chinese markets.<sup>75</sup> Nevertheless, an empirical analysis of public data for discriminatory application has proved to the contrary that no evidence indicates that the NSR is being

undertaken in a discriminatory manner.<sup>76</sup> This can be used to rebut the perceived country-based discrimination for which China may establish in retaliation to the detriment of US investors. Indirectly, the empirical data serves as a solid counterevidence in refuting that CFIUS impedes trade liberalisation in an arbitrary and capricious manner. It seems that CFIUS was not so much concerned about foreign ownership of wind farm assets, but rather the installation of Ralls' project so close to military assets.<sup>77</sup> The facts of the case provide valuable insight in the CFIUS review process and lessons for Chinese companies seeking to invest in assets geographically near sensitive defence instalments.<sup>78</sup> In a world of geopolitical tensions, acquisitions by firms from potential adversary countries, like China, will inevitably receive disproportionately intense scrutiny.<sup>79</sup> Given the political sensitivity surrounding inbound investment, for the foreseeable future, Chinese investment in strategic American sectors will continue to be scrutinised.<sup>80</sup> A Chinese company may have to go further than the law would seem to require.

### 3. The far-reaching implications

The case of *Ralls* will have substantial impact on foreign companies' M&As in certain sensitive industry sectors, which could also reshape long-standing procedures at CFIUS. It is considered a milestone since the court has held that the parties before CFIUS are entitled to procedural due process. The decision could give foreign firms more leverage and greater legal protections as they seek to expand in the US, which may open the door to potential legal challenge provided that parties are denied due process. As a setback for the CFIUS,<sup>81</sup> the landmark decision arguably weakened the President's ability to block foreign firms' acquisition on national security grounds.<sup>82</sup> The ruling will help create some transparency in the CFIUS process, which may facilitate the prospect of a more transparent process. Ralls' unprecedented legal victory over the CFIUS could shake up the secretive government review process that weighs the national security implications of foreign acquisitions in the US. Prior to the *Ralls* case, foreign companies have had virtually no say in the review process, but the ruling could result in requiring the CFIUS disclose the unclassified evidence upon which it relies in making decisions.<sup>83</sup> In addition, the challenge may increase the burdens on parties and result in lengthier and more rigorous investigations. Furthermore, under any scenario the authority of CFIUS to review acquisitions remains intact, its ability to call in unfiled transactions remains undisturbed. Last but not the least, another point worthy to note is the divestiture order may precipitate a possible tit-for-tat retaliation from the CFIUS's counterpart. In 2011 China established its own national security review regime that mirrors the operation of CFIUS. Given the de facto discriminatory consequences arising from such precedents as *Huawei* and *Ralls*, it is worth exploring whether the Chinese NSR regime could politicise potential American businesses in China.

## D. The National Security Review regimes in China

There has been a trend of heightened scrutiny of foreign investment into China in potentially sensitive sectors. If a transaction is determined to pose a significant concern to national security, parties may be required either to withdraw the transaction or to implement the mandatory remedies to address the concern. With increase in acquisitions of Chinese domestic companies by foreign investors, China has set up its own equivalent to US' CFIUS. Some concerns arise as to whether the US Congressional action to tighten restrictions on foreign investment in the US has provoked similar countermeasures in China, arguably limiting opportunities for outward investment by American companies. Even it remains uncertain whether national security could be used as a pretext for protectionism. It is worth focusing on the extent to which the Chinese NSR process is similar to, or distinct from the CFIUS.

### 1. The National Security Review (NSR) framework

The definition of national security has substantial impact on which cross-border mergers receive clearance, which conception impacts the legal regime surrounding the NSR review. Both the US and China use a deliberately open-ended definition of national security in both regulatory regimes.<sup>84</sup> Given the lack of sufficient parameters, a further effort needs to be made to circumscribe as clearly as possible what the concepts of national security means to avoid possible protectionist or discrimination. This new definition under FINSA makes the US practice more likely to appeal to Chinese Antimonopoly Enforcement Agencies (AMEAs), which is likely to influence the emerging Chinese NSR committee. China defines 'national security' much more broadly than does the definition used in CFIUS review. For instance, defence and high-technology industries are not the only sectors that potentially fall under the national security arena.

The Antimonopoly Law (AML 2008) provides for a separate review under a circumstance where foreigners' proposed transaction will have any adverse effect on nation security, in addition to the anti-monopoly review.<sup>85</sup> The statute paves the way for legitimate establishment of a framework for an NSR regime.<sup>86</sup> Under the supervision of the State Council institutionally, the NSR is conducted by a joint inter-ministerial committee (NSR Committee) led by MOFCOM. The NSR Committee is empowered to ensure that there are effective institutions in place, and clear lines of responsibility. It normally undertakes sophisticated assessment based on the following elements, among other things, national defence, national economic stability, basic social order and key technological R&D capability in connection with national security. More specifically, the NSR Committee will assess the transaction's impact on:

(i) national defence and security, including its impact on the production capacity of defence-related domestic products,

capacity of provision of defence-related domestic services, and equipment and facilities that are required for national defence;

(ii) national economic stability;

(iii) the basic order of life in society; and

(iv) research and development capabilities related to key technologies associated with national security.<sup>87</sup>

While China's emerging NSR procedures bear some resemblance to the CFIUS process, there are significant differences as well. Overall, both have the same basic goal to review foreign investments' implications on national security. As Plotkin presented in his testimony, the list of factors are neither intended to be an exhaustive definition of the scope of national security nor are they treated as such in practice.<sup>88</sup> The statutory inclusion indicated by the above 'national economic stability' is broad and hints at economic, rather than national security.<sup>89</sup>

The NSR system has been tainted by concerns about what China calls 'economic security', which could provoke protectionism when applied by the AMEAs.

## 2. The NSR Notice

China's State Council adopts an interdepartmental national security review system for foreign M&As. For better co-ordination and efficiency, China's State Council issued the 'Notice on Establishment of a Security Review System for the Merger and Acquisition of Domestic Enterprises by Foreign Investors' (hereinafter referred to as NSR Notice) on 3 February 2011.<sup>90</sup> It serves as a legal basis for the M&As security review system, and further refines China's procedures for reviewing certain foreign acquisitions of control over Chinese domestic enterprises. The issuance of NSR Notice represents a significant step forward in an effort to enhance transparency and formalise the NSR procedures. The NSR Notice goes far beyond traditional national security issues to encompass the 'economic stability' and 'the fundamental order of the society'. It leaves the terms 'national economic stability' and 'basic order of life in society' undefined, which is bound to establish a scope of review that is broader than the CFIUS review.<sup>91</sup> Furthermore, the definition of actual control covers a broad array of foreign investment scenarios. It is defined to include situations where any foreign investor or combination of foreign investors will hold more than 50 per cent of an enterprise's equity, or where voting rights give a foreign investor significant influence over shareholder meetings or board meetings.<sup>92</sup> It remains to be seen what would constitute 'significant influence', which results in a foreign investor being deemed to have acquired actual control.<sup>93</sup> Finally, the institutional void due to the overlap may create bureaucratic delays and impede NSR Committee's ability to efficiently implement the Article 31 under AML 2008.<sup>94</sup>

It seems highly challenging for foreign investors to navigate the interplay of the NSR regime with the anti-trust process,<sup>95</sup> particularly when inconsistent outcomes arise from the two investigations respectively. On 1 July 2015, the National People's

Congress passed the People's Republic of China National Security Law (NSL).<sup>96</sup> The NSL provides that certain types of foreign investments will be subject to NSR requirements.<sup>97</sup> On the one hand, the NSL has consolidated the integrity of the China's NSR on a statutory basis, on the other hand, the broad definition of national security embedded in the NSL could likely further complicate the M&As' review. The NSR injects uncertainty and complexity into cross-border deals.<sup>98</sup> It is critical to consider the NSR's impact on the timing and ultimate success of the transaction.<sup>99</sup> The longer a deal takes to approve, the more it costs and the more variables can affect the underlying transaction.<sup>100</sup> It is to be seen whether the NSR regime will result in economic protectionism constituting a serious obstacle for foreign MNCs. To a greater extent, it depends upon how it will be applied in practice given the NSR leaves substantial discretion to the enforcement agencies.<sup>101</sup> It is likely that the Chinese government will issue future guidelines for enforcing the national security review, especially in the M&As context, in light of the broader security concerns raised in the NSL.

## 3. The interplay between China's anti-monopoly clearance and the NSR

The NSR regime formalises the concept of NSR that is embodied in the existing foreign direct investment (FDI) approval regime. The clear separation of competition reasons from national security considerations would increase transparency and predictability. The interactive clarification between the new and the existing regimes is vital from a transaction management perspective. Nevertheless, the lack of a transitional explanation of the interrelationship between the complex governmental agencies jeopardises NSR efficacy. It is essential to examine the issue when a deal is to be subject to more than one review institutionally and hierarchically.

### (a) FDI approval v NSR regime

The interaction between the general FDI approval procedures and the NSR process remains uncertain. The NSR system does not replace any of the existing controls on M&As and foreign investment in China. It is possible that the new NSR regime will run parallel with other laws and regulations, since it makes little sense for a deal to go through separate reviews on national security grounds. The first measures providing for separate FDI review on national security grounds appeared in the M&As Rules.<sup>102</sup> However, on 16 February 2011, NDRC issued informal guidance indicating that foreign investors will not be required to make a separate filing to initiate a security review; rather, the parties may be asked to provide information necessary for the security review in the course of other regulatory reviews.<sup>103</sup> It appears that the NSR panel will proceed on the basis of information provided in the course of existing foreign investment approval processes. It is unclear whether the NSR is in effect part of the existing FDI approval framework.

Furthermore, China's FDI system has been progressively decentralised in recent years.<sup>104</sup> The local enforcement agencies have received greater authority to approve larger projects without central government involvement. The new NSR system makes it feasible to channel certain transactions to the NSR panel for review. It remains unclear as to whether local approval authorities should suspend their reviews or withhold their decisions pending the outcome of the NSR process, even for transactions that are unlikely to trigger such concerns. It is not clarified whether the notification for NSR should be submitted by the foreign investor directly to MOFCOM or through its local branches.

#### *(b) NSR vis à vis AML 2008*

AML 2008 specifies an NSR procedure for acquisitions of domestic companies by foreign investors. A foreign party could be subject to both an economic antitrust review and an additional NSR review. An NSR is required alongside merger control review if applicable where a foreign investor acquires actual control of a sensitive sector. Exceptionally, a review is required in any event if the sector involved is military or related sectors,<sup>105</sup> in which there is no minimum threshold. These transactions will be subject to review irrespective of whether they lead to a 'concentration' as defined in the AML 2008.<sup>106</sup> This approach seems to have been inspired by a decision in the US that effectively blocked proposed Chinese investments in mining companies that turned out to be proximate to military facilities.<sup>107</sup> Notably, not all transactions subject to merger review under the AML 2008 will be subject to NSR. An M&A is reviewable only if the foreign investor will gain 'actual control' of the enterprise in a key sector. And conversely, not all transactions subject to NSR will simultaneously be subject to merger control review. For instance, when the parties do not meet the merger control thresholds and MOFCOM does not sua sponte initiate an anti-trust review.<sup>108</sup> Nevertheless, the overlapping situation inevitably complicates the NSR where national security concerns are involved in both antitrust review and the NSR. It is neither clear as to how MOFCOM will treat transactions that are notified under both the AML control and the NSR Notice, nor certain about how to handle the risk of inconsistent outcome.

More specifically, the M&As Rules 2006 sought to protect the Chinese economy from any threats to its 'national economic security', which includes 'key industries' and 'famous brands'.<sup>109</sup> China's reluctance to let the well-known Chinese brand Huiyuan pass to foreign control seems to be a perfect example involving pure economic nationalism.<sup>110</sup> *Coca Cola-Huiyuan* shows that China's broadly defined national security concept has crept into AML enforcement.<sup>111</sup> It seems that the Chinese government plays a double role: it is both the owner of the major players and the referee, which is detrimental to the development of China's market economy.<sup>112</sup> This raises con-

cerns that protection of such SOEs from competition may be an aspect of 'national security' that is to be taken into account in the separate review.<sup>113</sup> A subtle issue arises as to whether the aim of 'national security' could be used to protect Chinese SOEs or national champions from competition where an acquisition does not threaten national security per se. It remains to be seen as to whether Article 12 of the M&As Rules 2006 has survived the enactment of Article 31 of the AML 2008; or whether the concept of protecting 'famous brands' in Article 12 is now encompassed in the NSR Notice. The lack of guidance could result in potential contradiction and increase the level of uncertainty.

#### **4. Far-reaching implications**

MOFCOM updated the NSR Provision which, together with the State Council's NSR Notice, will have a broad impact on structuring inbound M&A transactions undertaken by foreign investors. The procedural and substantive facets of the new NSR regime formalise the process and add some parameters, resembling analogous procedures for screening foreign investment on national security grounds in other major jurisdictions.<sup>114</sup> In particular, the structure reflects an analytical approach quite similar to that adopted by the CFIUS. In response to growing concerns of protectionism and nationalism, the NSR system marks the path forward by establishing a firm framework for review of foreign M&As on national security grounds. However, the NSR regime has been tailored to China's particular legal and policy environment, which inevitably renders the process opaque and discretionary. The rules will leave great discretion in the hands of the NSR panel. The screening may constitute a certain impediment to FDI, which could make transactions involving foreign acquirers more challenging. It remains uncertain whether the system will be applied arbitrarily to deter specific deals, or whether it will be implemented with openness and transparency. Whether they will constitute serious obstacles for foreign companies will depend largely upon how the rules are applied in practice.

#### **5. *Ralls'* repercussions: protectionism and tit for tat**

The *Ralls'* decision does have a tangible and material impact on the relations between the US and China. Politicised NSRs result in uncertainty for businesses and can even harm diplomatic relations between the two economy giants. More plausibly, the US approaches in dealing with the national security is always intrinsically highly regarded by the Chinese AMEAs, although they never openly admit for the sake of ideologism and propaganda. Such a delicate balance used to catalyse the institutional evolution in Chinese executive and judicial organs, which has substantially helped to level the playing field in various cross-border dealings. The *Ralls'* decision has, to a greater extent, shaken the trust in terms of the perceived high-quality implementation of the NSR practice. This has also sub-



stantially worsened the interaction since the US approach would not be appealing to the Chinese AMEAs, which would lower down the future practice and undermine the international investment environment as a result. A critical issue arises as to under which circumstances a blockage of foreign acquisitions constitutes protectionism. Seen through the lens of the legal architecture for review of foreign direct investment (FDI), it depends largely upon whether there is genuine national security rationale for blocking a proposed acquisition. It seems vague whether national attempts to block foreign acquisitions become a new protectionist drift that interferes with the free flow of capital and technology across borders.<sup>115</sup> Without a proper resolution, this would trigger reciprocal retaliation and undoubtedly hurt the both countries foreign investments.

The Chinese NSR regime could have a broad impact on prospective M&As by US investors. More specifically, any improper process of the Chinese investment will risk subjecting US businesses to similar sufferings when they invest in China. This is because the scope of NSR is ambiguous and could be an option of last resort for the Chinese authorities to block a transaction at its discretion.<sup>116</sup> The NSR provision under the AML 2008 reflects the resurgence of protectionist sentiments following the increase in foreign acquisitions of Chinese companies.<sup>117</sup> The NSR could be used as a shield to protect domestic industry in the context of strategic industrial policy,<sup>118</sup> and to challenge foreign MNCs that are increasingly controlling the Chinese economy. Notably, the NSR Notice followed several high-profile rejections of Chinese firms' acquisitions on national security grounds. For instance, the creation of the new NSR coincided with CFIUS's high-profile ruling against an acquisition in the US by Huawei.<sup>119</sup> It might have potentially opened a door to retaliation against those perceived protectionism. It remains highly datable as to whether the NSR Notice will bring greater transparency to an opaque process or consistent with Chinese perceptions of the CFIUS, which serves mainly to establish a highly politicised forum for protectionist interests.

In essence, neither statutes nor institutions provides objective criteria to help prospective acquirers to be well informed as to what kind of transaction is likely to be rejected on national security grounds. The NSR mechanism adds to the regulatory burden of foreign acquirers, as well as additional costs and unpredictability to a proposed acquisition. Whether these rules will constitute serious obstacles will depend upon how the NSR regime is applied. In the interests of a level competitive playing field as well as regulatory symmetry, a more transparent and predictable NSR regime is highly expected in the long term. Both the US and China will benefit greatly from eliminating politicised treatment of the investments, which would strengthen the reciprocal effect when one party demands similar treatment from another when its MNCs investing in the overseas markets.<sup>120</sup>

## **E. Stalemate between national security and economic competitiveness**

The CFIUS process carries with it significant amount of unpredictability.<sup>121</sup> The difficulty of balancing economic competitiveness and national security seems to have resulted in stalemate.<sup>122</sup> Such an issue has been further plagued by mutual suspicion and distrust between the two countries.<sup>123</sup> To separate plausible national security threats from implausible claims that a foreign acquisition will threaten national security, it is vital to strike the right balance between proving a predictable investment environment and ensuring national security.<sup>124</sup> Disconcertingly, both CFIUS and Chinese NSR system have been considered as a trade barrier dressed up as a national security tool, signalling the deep untrustiness between each other. FDI and national security need not be zero sum in combination.<sup>125</sup> The two pillars of the goal are not necessarily be exclusive but complementary.

### **1. Safeguarding national security without stifling free trade**

Given the global nature of supply chains, the potential risk to national security cannot be eliminated. It is indispensable to develop an integral processing procedure in which risks can be strategically mitigated.<sup>126</sup> Screening foreign acquisitions for potential threats to national security, CFIUS needs the flexibility to focus its scarce resources on those FDIs that create real risks.<sup>127</sup> Otherwise, it would compromise considerably CFIUS's ability to deal with those transactions that genuinely matter. The NSR policies should be clarified so that the benchmarks and hurdles facing Chinese investors are understood relatively well, which will lead to a win-win outcome in achieving sustainable growth for the two economies. After all, more predictable NSRs would likely attract more Chinese investment in the US, given that China holds an estimated \$3.9 trillion in foreign reserves.<sup>128</sup> It is essential for the NSR to be undertaken in a reasonably objective manner, so as to avoid precipitating protectionist and retaliatory influence.<sup>129</sup> As Rose observed:

'Clarification would help inoculate CFIUS against claims that its decisions are susceptible to political manipulation, and that increased frictions for certain deals, particularly from political and economic rivals, are not "by design".'<sup>130</sup>

More disclosure of the justifications in Ralls for the divestiture order would make CFIUS reviews more predictable and provide foreign investors with a better sense of the types of investments that are likely to create national security concerns.<sup>131</sup>

### **2. Compliance with CFIUS procedures: making efficient use of voluntary filing**

The resort to judicial recourse *ex post* will necessarily increase uncertainty for all parties in a transaction.<sup>132</sup> However, the use of appropriated tailored CFIUS mitigation procedure can minimise the side effect. The current voluntary notification system allows the parties to know CFIUS's decision with relative certainty prior to closing the transaction. The main benefit is that

company can take advantage of a regulatory 'safe harbour' that protects it from further scrutiny or executive action.<sup>133</sup> This enables the parties to avoid substantial damage in the bud. Moreover, the system of confidentiality enables parties to avoid negative publicity typically associated with a CFIUS investigation. If the parties intend to sidestep such a procedure,<sup>134</sup> CFIUS may initiate review *sua sponte* at any time and impose measures to mitigate security risk, including possible divestiture following a completed acquisition.<sup>135</sup> As such, transactions that are not voluntarily filed and are later reviewed begin at a distinct disadvantage.<sup>136</sup> Acquisitions that sidestep CFIUS review proceeded at Ralls's peril, as was clearly demonstrated by the President's decision in 2012 to unwind the Ralls' acquisition.<sup>137</sup> Had it filed a notice and had CFIUS cleared it, the deal would have been insulated from subsequent rigorous review. It would be helpful to engage in informal pre-notification consultation with CFIUS to discuss the transaction, filing documentation and possible remedies. Otherwise, a proposed transaction would remain indefinitely subject to divestment or other action. It would be prudent to voluntarily seek CFIUS review when there appears to be even a remote possibility of national security concerns,<sup>138</sup> which not only builds credibility with CFIUS, but also helps mitigate potential risks arising from the NSR.<sup>139</sup> Ralls should have taken as broad as possible a view of what the CFIUS might deem to be of national security concern so as to avoid potential judicial deadlock. Even were that not possible, Ralls might have avoided the costs and adverse press of an acquisition and forced divestiture.

### 3. Is there a genuinely well-justified ground?

As a common practice, legitimate competitive and national security concerns need to be addressed.<sup>140</sup> Under the world's prominent international trade regimes, a nation has the right to deny foreign investment in areas of the economy deemed integral to its national security interests.<sup>141</sup> Certain prospective acquisitions of US assets present legitimate security risks that may warrant intervention.<sup>142</sup> A subtle issue remains uncertain whether the process is completely apolitical and immune from insider manoeuvring.<sup>143</sup> Although the CFIUS regulations specifically disavow economic protectionism and reiterate US government policy to encourage foreign direct investment (FDI), an intrusive CFIUS would be an unintended protectionist barrier, and also risk undermining the US's goal of greater investment access to foreign market.<sup>144</sup> The US has had adequate control in place to review and block those prospective M&As with national security risks. The rigorous assessment do deter those inward acquisition even with any potential threat to national security from entering into the US market. Such sophisticated institutional and regulatory mechanism have been successful in balancing the need for foreign investment against the threat of national security.<sup>145</sup> In no way can Chinese M&As be said to be compromising the national security.<sup>146</sup>

Ideally, to mitigate the issue of stalemate depends upon the extent to which the regulatory can enhance transparency and improve external perceptions. Paradoxically, the requirement of transparency contradicts the legal mandate of the non-disclosure of the assessment methods and criteria by the intelligence agencies on behalf of CFIUS. Given the absence of well-informed criteria in the CFIUS legal regime, it is hard to evaluate the extent to which the Ralls case will change the transparency of CFIUS assessments. Without such kind of details available, it is infeasible to undertake an objective evaluation of legitimacy and justification of the CFIUS's approaches. In this vein, hardly will Chinese objectives be realised for more predictable and transparent treatment. It seems a long way to go from treating all investors in a fair and equitable manner under the law. The conflict on the national security ground would have to be addressed through a bilateral investment treaty between the US and China.<sup>147</sup> The fact that China has more restrictions on foreign investment than its counterpart would play a leverage role in resolving the chronic problem haunting the both jurisdictions.

### Conclusion

Given the global nature of supply chains and M&As, there will be inevitably prospect of damaging conflict between the commercial interests and the national security, hence the increase government scrutiny of cross-border acquisitions. The screening process represents an integral part of the existing foreign investment approval procedures. The NSR regime could make transactions involving foreign acquirers more challenging to navigate, increasing the level of uncertainty in the foreign investment approval process. The case demonstrates that the US harboured deep concerns on national security grounds. As a result, FINSA expands dramatically the mandate given to CFIUS by Exon-Florio. Ralls's failure to notify CFIUS *ex ante* rendered it infeasible for the plaintiff to modify its terms before the President's divestiture order. It should have done to avoid the uncertainty of CFIUS interfering in the deal after consummation. After all, rational as the Chinese investor's requirement is, CFIUS's risk assessment for the Ralls transaction was based on classified information that is generally not susceptible to public disclosure. Any potential foreign acquirers should seek approval of CFIUS prior to closing the deal. Plausibly as it may be, the NSR result *de facto* in a politicised process. As such protectionism and governance discriminatory scrutiny may precipitate retaliation from each other, to the detriment of the global economic recovery. The NSR institutions need to adapt to a constantly evolving national security landscape and evaluate each transaction on a case-by-case basis. It will be beneficial for the world economy for the both the CFIUS and Chinese NSR systems to feature an intricate balance in protecting national security while promoting national economic interests.



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- 12 50 USC app § 2170 (l) (1); 50 USC app § 2170(a) (3) A 'covered transaction' is defined as 'any merger, acquisition, or takeover ... by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States.'
- 13 Foreign Investment and National Security Act § 2(b)(1)(E); § 2(b)(2)
- 14 50 USC app § 2170(b)(1)(A)
- 15 50 USC app §§ 2170 (b)(2)(B)(i)(I), (d)(2)
- 16 50 USC § 2170(b)(1)(C)(i)
- 17 Foreign Investment and National Security Act of 2007, Pub L No 110-49, 121 Stat. 246 (2007)
- 18 50 USC app § 2170 (e)
- 19 The last transaction blocked on CFIUS grounds was by then-

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- 28 31 CFR § 800.506(b); Executive Order 11858: Order Regarding the Acquisition of Four US Wind Farm Project Companies by Ralls Corporation (28 September 2012)
- 29 *Ralls Corp v Terna Energy USA Holding Corp*, 920 F Supp 2d 27 (DDC 2013)
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- 31 *Ralls Corporation v Committee on Foreign Investment in the United States, et al*, US District Court for the District of Columbia (No 1:12-cv-01513, July 15, 2014)
- 32 *Ralls Corp v Barack H Obama, et al*, Case No 1-12-cv-01513 (DDC Sept. 12, 2012) Ralls' complaint was filed prior to the issuance of the Presidential Order on 28 September 2012, thus, challenged only the CFIUS Order. Subsequent to the issuance of the Presidential Order, Ralls amended its complaint to include claims against the President. Amended Complaint in *Ralls Corp v Barack H Obama, et al*, Case No 1-12-cv-01513 (DDC Oct. 1, 2012)
- 33 Administrative Procedures Act s10
- 34 Section 721 of the Defence Production Act 1950, as amended, 50 USC app § 2170 d) (1) (2012)



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